

the purview of section 306(c)(1)(B). Common stock which is convertible into stock other than common stock or into property, shall not be considered common stock. It is immaterial whether the conversion privilege is contained in the stock or in some type of collateral agreement.

(g) If there is a substantial change in the terms and conditions of any stock, then, for the purpose of this section—

(1) The fair market value of such stock shall be the fair market value at the time of distribution or the fair market value at the time of such change, whichever is higher;

(2) Such stock's ratable share of the amount which would have been a dividend if money had been distributed in lieu of stock shall be determined by reference to the time of distribution or by reference to the time of such change, whichever ratable share is higher; and

(3) Section 306(c)(2) shall be inapplicable if there would have been a dividend to any extent if money had been distributed in lieu of the stock either at the time of the distribution or at the time of such change.

(h) When section 306 stock is disposed of, the amount treated under section 306(a)(1)(A) as ordinary income, for the purposes of part I, subchapter N, chapter 1 of the Code, be treated as derived from the same source as would have been the source if money had been received from the corporation as a dividend at the time of the distribution of such stock. If the amount is determined to be derived from sources within the United States, the amount shall be considered to be fixed or determinable annual or periodic gains, profits, and income within the meaning of section 871(a) or section 881(a), relating, respectively, to the tax on non-resident alien individuals and on foreign corporations not engaged in business in the United States.

(i) Section 306 shall be inapplicable to stock received before June 22, 1954, and to stock received on or after June 22, 1954, in transactions subject to the provisions of the Internal Revenue Code of 1939.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 7281, 38 FR 18540, July 12, 1973; T.D. 7556, 43 FR 34128, Aug. 3, 1978]

§ 1.307-1 General.

(a) If a shareholder receives stock or stock rights as a distribution on stock previously held and under section 305 such distribution is not includible in gross income then, except as provided in section 307(b) and § 1.307-2, the basis of the stock with respect to which the distribution was made shall be allocated between the old and new stocks or rights in proportion to the fair market values of each on the date of distribution. If a shareholder receives stock or stock rights as a distribution on stock previously held and pursuant to section 305 part of the distribution is not includible in gross income, then (except as provided in section 307(b) and § 1.307-2) the basis of the stock with respect to which the distribution is made shall be allocated between (1) the old stock and (2) that part of the new stock or rights which is not includible in gross income, in proportion to the fair market values of each on the date of distribution. The date of distribution in each case shall be the date the stock or the rights are distributed to the stockholder and not the record date. The general rule will apply with respect to stock rights only if such rights are exercised or sold.

(b) The application of paragraph (a) of this section is illustrated by the following example:

Example A taxpayer in 1947 purchased 100 shares of common stock at \$100 per share and in 1954 by reason of the ownership of such stock acquired 100 rights entitling him to subscribe to 100 additional shares of such stock at \$90 a share. Immediately after the issuance of the rights, each of the shares of stock in respect of which the rights were acquired had a fair market value, ex-rights, of \$110 and the rights had a fair market value of \$19 each. The basis of the rights and the common stock for the purpose of determining the basis for gain or loss on a subsequent sale or exercise of the rights or a sale of the old stock is computed as follows:

100 (shares) × \$100 = \$10,000, cost of old stock (stock in respect of which the rights were acquired).
100 (shares) × \$110 = \$11,000, market value of old stock.
100 (rights) × \$19 = \$1,900, market value of rights.
11,000/12,900 of \$10,000 = \$8,527.13, cost of old stock apportioned to such stock.
1,900/12,900 of \$10,000 = \$1,472.87, cost of old stock apportioned to rights.

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If the rights are sold, the basis for determining gain or loss will be \$14.7287 per right. If the rights are exercised, the basis of the new stock acquired will be the subscription price paid therefor (\$90) plus the basis of the rights exercised (\$14.7287 each) or \$104.7287 per share. The remaining basis of the old stock for the purpose of determining gain or loss on a subsequent sale will be \$85.2713 per share.

§ 1.307-2 Exception.

The basis of rights to buy stock which are excluded from gross income under section 305(a), shall be zero if the fair market value of such rights on the date of distribution is less than 15 percent of the fair market value of the old stock on that date, unless the shareholder elects to allocate part of the basis of the old stock to the rights as provided in paragraph (a) of § 1.307-1. The election shall be made by a shareholder with respect to all the rights received by him in a particular distribution in respect of all the stock of the same class owned by him in the issuing corporation at the time of such distribution. Such election to allocate basis to rights shall be in the form of a statement attached to the shareholder's return for the year in which the rights are received. This election, once made, shall be irrevocable with respect to the rights for which the election was made. Any shareholder making such an election shall retain a copy of the election and of the tax return with which it was filed, in order to substantiate the use of an allocated basis upon a subsequent disposition of the stock acquired by exercise.

EFFECTS ON CORPORATION

§ 1.312-1 Adjustment to earnings and profits reflecting distributions by corporations.

(a) In general, on the distribution of property by a corporation with respect to its stock, its earnings, and profits (to the extent thereof) shall be decreased by—

- (1) The amount of money,
- (2) The principal amount of the obligations of such corporation issued in such distribution, and
- (3) The adjusted basis of other property.

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For special rule with respect to distributions to which section 312(e) applies, see § 1.312-5.

(b) The adjustment provided in section 312(a)(3) and paragraph (a)(3) of this section with respect to a distribution of property (other than money or its own obligations) shall be made notwithstanding the fact that such property has appreciated or depreciated in value since acquisition.

(c) The application of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example (1). Corporation A distributes to its sole shareholder property with a value of \$10,000 and a basis of \$5,000. It has \$12,500 in earnings and profits. The reduction in earnings and profits by reason of such distribution is \$5,000. Such is the reduction even though the amount of \$10,000 is includible in the income of the shareholder (other than a corporation) as a dividend.

Example (2). The facts are the same as in *Example (1)* above except that the property has a basis of \$15,000 and the earnings and profits of the corporation are \$20,000. The reduction in earnings and profits is \$15,000. Such is the reduction even though only the amount of \$10,000 is includible in the income of the shareholder as a dividend.

(d) In the case of a distribution of stock or rights to acquire stock a portion of which is includible in income by reason of section 305(b), the earnings and profits shall be reduced by the fair market value of such portion. No reduction shall be made if a distribution of stock or rights to acquire stock is not includible in income under the provisions of section 305.

(e) No adjustment shall be made in the amount of the earnings and profits of the issuing corporation upon a disposition of section 306 stock unless such disposition is a redemption.

§ 1.312-2 Distribution of inventory assets.

Section 312(b) provides for the increase and the decrease of the earnings and profits of a corporation which distributes, with respect to its stock, inventory assets as defined in section 312(b)(2), where the fair market value of such assets exceeds their adjusted basis. The rules provided in section 312(b) (relating to distributions of certain inventory assets) shall be applicable without regard to the method used